

INTERNAL REVENUE SERVICE  
Uniform Issue List Number: 408A.00-00

July 12, 2000

Number: **INFO 2000-0163**  
Release Date: 9/30/2000

Dear [REDACTED]:

This letter is in response to correspondence we received from the [REDACTED] on your behalf. The [REDACTED] enclosed a copy of correspondence from you to [REDACTED] complaining about your IRA trustee's or custodian's use of the method in the Income Tax Regulations (the Regulations) for calculation of the net income attributable to a contribution being recharacterized under section 408A(d)(6) of the Internal Revenue Code. We believe the following general explanation of the proper way to calculate the net income attributable to contributions being recharacterized will be helpful to you.

Section 1.408A-5 A-2(a) of the Regulations provides that the net income attributable to the amount of a contribution that is being recharacterized must be transferred along with the contribution. Your IRA trustee or custodian is correct that the amount of net income attributable to a contribution being recharacterized must be calculated using one of the methods provided in the Regulations. Section 1.408A-5 A-2(b)&(c) of the Regulations provides two methods for this determination. Under the first method, if the contribution that is being recharacterized was contributed to a separate IRA and no distributions or additional contributions have been made from or to that IRA at any time, then the contribution is recharacterized by the trustee transferring the entire account balance. In this case, the net income (or loss) attributable to the contribution being recharacterized is the difference between the amount of the original contribution and the amount transferred. Under the second method, which must be used in all other cases, the net income attributable to the amount of a contribution that is being recharacterized is calculated in the manner prescribed by section 1.408-4(c)(2)(ii) of the Regulations (disregarding the parenthetical clause in section 1.408-4(c)(2)(iii)).

Section 1.408-4(c)(2)(ii) of the Regulations provides the method for calculating the net income attributable to excess contributions made to an IRA and returned before the due date of the return. In order to use this method to calculate the net income attributable to the amount of a contribution being recharacterized, you generally must substitute the

term “amount of the contribution being recharacterized” for the term “excess contribution.” As so modified, section 1.408-4(c)(2)(ii) provides that the amount of net income attributable to the amount of the contribution that is being recharacterized is an amount which bears the same ratio to the net income earned by the account during the computation period as the amount of the contribution being recharacterized bears to the sum of the balance of the account as of the first day of the taxable year in which the amount of the contribution being recharacterized is made and the total contribution made for such taxable year. The term “computation period” means the period beginning on the first day of the taxable year in which the amount of the contribution being recharacterized is made and ending on the date of the transfer from the account.

Section 1.408-4(c)(2)(iii) of the Regulations, as modified for recharacterizations, further provides that the net income earned by the account during the computation period is the fair market value of the balance of the account immediately after the distribution increased by the amount of distributions from the account during the computation period, and reduced by the sum of: (A) the fair market value of the balance of the account as of the first day of the taxable year in which the amount of the contribution being recharacterized was made and (B) the contributions to the account during the computation period.

The Internal Revenue Service has received comments that the second method described above does not always reflect the actual earnings and losses of the IRA during the time it held the contribution being recharacterized. This is due to the fact that, under this method, account activity in the part of the year that precedes the date the contribution being recharacterized was made is taken into account in the calculation of the net income attributable to such contribution. In response to these comments, the Service and Treasury have recently issued Notice 2000-39, which is scheduled to be published in the 2000-30 issue of the Internal Revenue Bulletin on July 24, 2000 (copy enclosed). Notice 2000-39 provides a new method for calculating net income attributable to a contribution on the actual earnings and losses of the IRA during the time it held the contribution. However, this new method only may be used for purposes of allocating net income to a contribution made to an IRA after December 31, 1999. In any event, it is not clear that this new method would produce a significantly different result from the pre-existing method used in your case, because the contribution that you recharacterized was originally made in January, rather than later in the year.

Please note that under both the old method and new method for calculating net income discussed above calculations are based on the overall value of an IRA and the dollar amounts contributed, distributed, and recharacterized to or from the IRA, rather than on specific investments made with a particular contribution.

We hope that the information included in this letter will be of assistance to you. If you have additional questions or concerns, please contact Cathy Vohs of my staff at (202) 622-6090 (not a toll-free number).

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Sincerely,

Michael J. Roach  
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(Employee Benefits)  
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